



Legal Beat

By Michael Sean Quinn

Agent Indemnification: How Not to Get Burned

Once in a blue moon, the Supreme Court of Texas decides a case that squarely pertains to insurance agents. On April 20, 2000, Justice Alberto Gonzales, writing for a unanimous court, decided an odd one, with potential significance. It concerned an agent's right to indemnification from a carrier arising from an agency agreement.

Defining "indemnity"

The legal term "indemnity" is a confusing one, especially in the context of insurance. We need to spend some arduous and unpleasant time on it. Only lawyers can love this idea.

In general, when A indemnifies B, it is with respect to some specific payment of money. There is no such thing as complete and total, general and global indemnification. Thus, A must indemnify B with respect

to a particular x. When this happens, A promises that if B has to pay money as the result of x, then A will reimburse B. In the absence of explicit verbiage, indemnification agreements are focused and limited 100 percent agreements. Thus, if A indemnifies B against x, A has agreed to repay whatever B has to pay as a result of x. Indemnity agreements can be fractionalized into percentages, and they can be subject to limits, either upper or lower. Such is the first and oldest idea of indemnity.

Insurance has stretched the concept of indemnification and created additional concepts of it. Here is the second one. A first-party insurer may be said to indemnify an insured against a loss. In the strict sense of "indemnify," the insured-indemnitee would have to pay out money in order to get money from his indemnitor-insured. Such a require-

ment makes no sense in the context of insurance, given its purposes. Hence, the concept of indemnity was modified.

The second, less rigid, insurance-related use of the concept of indemnity does not require the insured to replace or fix the item lost or damaged before the insurer has an obligation to pay. Under this usage of the word "indemnity," a loss just by itself is sufficient to trigger an insured's right to payment from the insurer. An actual cash payment by the insured resulting from the loss is not required. Besides, the insured had suffered a real financial loss. In the context of property insurance, his stuff would have been destroyed.

While this second use of the term "indemnity" is characteristic of first-party policies, there is yet a third use of the term that is characteristic of liability insurance. Long ago, liability insurance policies said explicitly that an insurer would indemnify an insured against judgments (of a specified sort—say, resulting from negligence) he might have to pay someone else. Originally, this language meant that the insured-tortfeasor had to pay the injured victim before the insurer had a duty to pay him.

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But insurance involves important economic and service functions, and resolving disputes with dispatch is almost always more efficient—and therefore cheaper—than prolonging them. Consequently, most good liability insurers ignored the language of their contracts, bypassed the you-pay-first requirement built into the concept of indemnity, and made payments on behalf of liable insureds without forcing them to pay first.

After that, courts became impatient with what they regarded as hiding-behind-a-technicality when some insurers sought to enforce the you-pay-before-I-do requirement in the literal meaning of the term “indemnity.” In effect, the courts treated the word “indemnity” as ambiguous. Of course, all ambiguous terms in insurance policies are construed in favor of coverage, so the term “indemnity” lost its original meaning, and liability insurers were required to make payments on behalf of liable insureds even when the insured didn’t or couldn’t do so.

Eventually, many liability policies were changed so that insurers expressly agreed to make payments on behalf of insureds, if the insured were found liable in a covered way. Interestingly, this wording-change in the insuring agreement has restored the useful-

ness of the original meaning of “indemnity.” Some insurance policies now use the old word, “indemnity,” and go on expressly to say that the insurer will pay only if an insured has already paid. In effect, this makes an insured’s solvency a condition precedent upon coverage. Such a provision can be very helpful to an insurer in the age of mass torts, class actions and huge judgments.

Third party vs. first party coverage

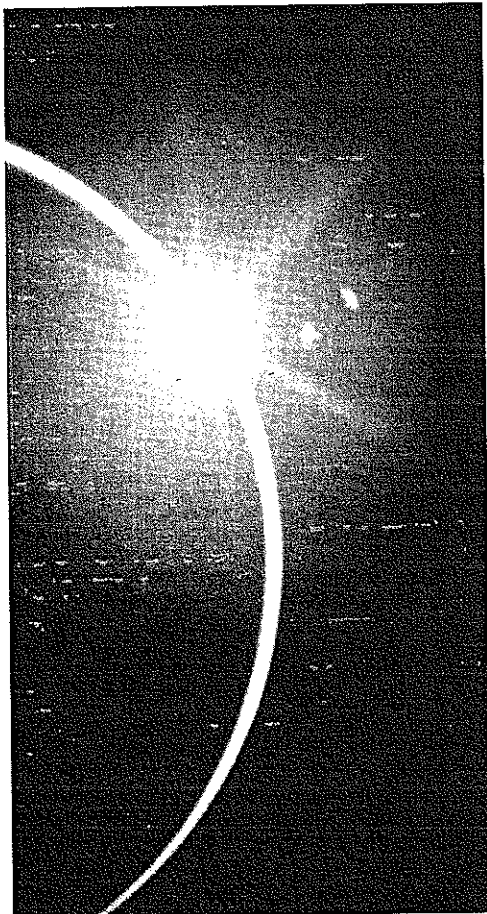
It is standard nowadays to distinguish between third-party insurance (liability insurance) and first-party insurance (such as property insurance). Historically, the core meaning of the term “indemnify,” in the context of liability insurance, destroys the distinction between third-party insurance and first-party insurance. To put the matter another way, when the term “indemnity” is understood literally in the context of liability insurance, third-party insurance becomes first-party insurance. After all, under a true indemnity policy, an insurer can never have contract-based obligations to anyone but the insured.

It is interesting to watch claimants and insureds try to manipulate litigation situa-

tions when the tortfeasor-insured is covered only by a true indemnity policy. Naturally, the tortfeasor-insured doesn’t want to part with his cash. Frequently he doesn’t have any to part with. One gambit is for the tortfeasor covered by a true indemnity policy to give the tort victim a note and then seek payment from the insurer-indemnitor. Courts are impatient with this sleazy and transparent artifice.

Another, slightly more probable-looking move, is for someone to borrow money and gives it to the insured-tortfeasor, who then hands it to the tort victim, and then tries to get indemnity from the insurer. Of course, somehow the borrowed money is supposed, to get back to the original lender. This is a rather risky maneuver, unless all the players are trustworthy. (And how can they be, since they are all trying to cheat the insurance company?) The entire machination is subject to discovery, of course, and the more it looks like illusionary paper shuffling—as opposed to a true transfer of cash—the less likely it is that the insurer-indemnitor will have to pay in the end.

In pondering such matters as this, it is advisable to keep the following fundament of business in mind. *Axiom One:* Most



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lawyers are tempted to be tricksters. *Axiom Two*: Some lawyers are tricky devils.

Another maneuver is for an insured-indemnitee to sue his agent complaining that the agent misrepresented the nature of the policy. The gist is that the agent did not explain the nature of a true indemnity policy but gave the insured the impression that the insurance company would make payments on his behalf, even if he did not or could have made payments first.

Agents need to be careful here. Very probably, if an agent sells a true indemnity policy, the nature of the policy should not only be explained fully to the buyer, there should be some sort of memorial of that explanation in a letter to the insured. Remember *Axiom Two*.

Common law indemnity

We must also keep in mind that the concept of indemnity is not restricted to contracts of indemnity only, whether they are insurance contracts or some other kind. There is such a thing as common law indemnity, where A can become the indemnitor of B by operation of law, as opposed to through some sort of agreement.

Manufacturers owe retailers indemnity, for example, if the retailers are sued because the manufactured goods are defective in some way, and the manufacturer is strictly liable. Thus, the right to indemnity may arise out of a relationship. Traditionally, the law said that there was an implied contract of indemnity between the manufacturers and retailers, as well as others in the distribution chain. The idea of an implied contract is obviously fictional, although hardly novel.

Significantly, other relationships may also give rise to rights of indemnity. Thus, an employer might owe a liable employee indemnity if the innocent employee ends up liable to a third party. The same is true among partners, principals and agents, and some other human connections.

The distinction between contractual and common law indemnity is occasionally important to understanding insurance. Sometimes, if A is the common law indem-

nitor of B, and A has liability insurance, an insurer of A may have to make payments not only on behalf of A but on behalf of B. The same thing is also often true when A is the indemnitor of B as the result of an express contract. This kind of insurance often requires extra contract language and sometimes a separate coverage part. Of course, in order to be insured, any such contract of indemnity must precede the injury-causing event for which a right of indemnity is created.

The extent to which liability insurance covers indemnifications for accidents is not the topic of this essay, however. Our focus is agents, agency agreements and their indemnity provisions.

Gulf Ins. vs. Burns Motors

Thus, the case decided by the Supreme Court of Texas on April 20, 2000, has to do with the ordinary contract sense of indemnity, not with the insurance contract sense of indemnity. This is true even though the problem arose in the context of an insurance transaction. Confusing, isn't it? No wonder people hate lawyers.

In *Gulf Insurance v. Burns Motors, Inc.*, two insurers entered into an agency-insurer agreement with Leroy Nash. He sold Burns Motors three insurance policies. Several dissatisfied customers sued Burns. The insurers disclaimed coverage. Apparently, the position of the insurers was

his contractual indemnity rights against the insurer to the insured, his former policy-purchasing customer.

The relevant parts

Only two of the agent's indemnity rights under the agency-insurer agreement were relevant. First, the insurer indemnified the agent against any liability he might have because of an error on the part of the insurer "in its processing or handling direct billed [accounts] or any other business placed" by the agent with the insurer, except to the extent that the agent has "caused, contributed to or compounded such error." Second, the insurer agreed to reimburse the agent for legal or other expenses that the agent reasonably incurred in connection with investigating or defending "any such liabilities."

In other words, if the agent caused, contributed to, or compounded any problem giving rise to liability, there would be no right of indemnity under the agent-insurer contract. There would be an absence of a contractual right of indemnity both as to substantive recoveries and as to legal fees.

The agreed judgment recited that Nash had knowingly made representations that turned out to be false. It also recited that the representations Nash made to Burns were made to him by the insurer.

Obviously, if Burns made a representation deliberately, knowing it to be false, then he would be compounding the insurer's original error—at

the very least—and would not be entitled to indemnity. (Of course, this proposition assumes that the insurer originally made a false representation to the agent.)

Consequently, Burns—as Nash's assignee—in the indemnity case against the insurer's, took the position that the word "knowingly" modified only the word "representations," and not whether those representations were true or false. In other words, Burns advanced the view that Nash knew that he was saying something, and knew what he was saying, but did not know that it was false. No wonder people think that lawyers are too, too clever, overly-subtle scoundrels.

A indemnifies B
X
A indemnifies B

plausible, because Burns sued Nash, but not the insurers.

The principal theory Burns deployed against Nash was the Texas Deceptive Trade Practices Act. In other words, Burns said Nash lied to Burns whilst selling it something. After several years of litigation, Nash entered into an agreed judgment with Burns, stipulating actual damages, treble damages, and attorneys' fees—the total exceeding \$250,000. Not only did the agent and the insured agree to the judgment, the insured agreed not to try to collect the judgment from the agent, and the agent assigned all of

Nevertheless, the position of Burns was not obviously wrong, given the way the agreed judgment was worded. Remember, the agreed judgment stated that Nash "did knowingly make...representations based upon the initial erroneous advise of [the] insurance companies and while acting as an agent in law for such companies." Taken in isolation, it is not clear from this sentence what the word "knowingly" modifies. Lawyers edit with a biased pen, much to the prejudice of society.

When taken in context, however, the

meaning of the word "knowingly, is quite clear. The agreed judgment creates liability under the DTPA. Under that statute, the word "knowingly" meant, at the time the judgment was entered, "actual awareness of the falsity, deception, or unfairness of the act or practice giving rise to the consumer's claim[.]"

The judgment went on to assess multiple damages under the DTPA. These two facts entail that the word "knowingly" in the judgment must mean that Nash knew of the falsity of what he said. Indeed, Burns pressed exactly that position in the original case

against Nash and accepted an agreed judgment upon these terms. Now its lawyers do an about face.

The Supreme Court choked. It swallowed none of this argument. As a consequence, the insurers had no duty to indemnify their agent Nash, or his assignee Burns (the original named insured), precisely because Nash (at the very least) contributed to the problem.

The decision's reach

The Supreme Court's unanimous holding in *Burns Motors* is really quite narrow. For example, the court did not consider how an indemnitor could be required to pay an indemnity, when the indemnity had made no payment to the person he injured. Remember, no insurance policy was involved here. What was involved was an orthodox indemnity agreement.

Burns Motors, as written, won't directly affect most agents. Careless lying is not very common, and the procedural tangle in the case is rare. Nevertheless, *Burns Motors* has broader implications.

Agents should take a careful look at the contracts of indemnity they have with insurers. They should try to negotiate them to be as broad as possible. The contract between Nash and his two carriers was quite narrow. Nash had few rights. The insurers indemnified him only if he had liability for what they did, and he had no culpable involvement in creating liability. Some insurers enter into broader contracts of indemnity. Agents should consider negotiating hard for broader indemnity agreements.

Agent E&O carriers might be helpful here. After all, it is in their interest to shift as much liability as possible to the insurer-principals of the agents.

Agents should not, however, expect to be either indemnified or insured against their own fraud. One wonders if agents should expect to be indemnified by the insurers they represent against their own negligent misrepresentations. Probably not, unless the insurer has made some contribution to the error. Dealing with negligent misrepresentations is what agent E&O insurance is really for. ■

Quinn is an Austin shareholder in the law firm of Sheinfeld, Maley & Kay. He is mostly involved in litigation problems involving insurance coverage. Many of the problems upon which he works involve conduct of lawyers.



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